TWO TRENDS IN THE REGULATION OF THE PUBLIC CORPORATION

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The public corporation is being shaped by two major trends moving in opposite directions. The first trend involves increasing federal regulation of corporate governance and has made it more costly to be a public company. The second trend involves decreasing regulation of the public offering and has reduced the costs for public companies when they sell securities. This essay examines the interaction between these two trends. Costs imposed by governance requirements can be offset by reducing the cost of public offerings. Or, the relationship may run the other way. When lenient public offering rules increase the risk of fraud, they can prompt greater governance regulation. Examining the links between the two trends suggests that access to the public offering is increasingly conditioned on meeting uniform corporate governance standards. Though governance reform may have its benefits, a danger of increasing federal corporate governance regulation is pressure to decrease protections for investors.

I. INTRODUCTION

Two major trends moving in opposite directions are defining the regulation of the public corporation. The first trend involves increasing federal regulation of corporate governance. Spurred in part by the collapse of a number of prominent public companies, the securities laws have been used to require public companies to adopt uniform governance measures. The second trend involves reduced regulation of the public offering. Over the last several decades, the Securities and Exchange Commission (SEC) has relaxed regulation of companies, especially large public ones, when raising funds through public offerings. The first trend has increased the costs of being a public company while the second trend has reduced the costs for public companies when they sell securities.

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As a result of these trends, the gap between public and private companies has grown larger.[1] Only companies with significant resources can easily meet the governance obligations that have been imposed through the federal securities laws. Only companies that meet federal governance obligations are permitted to access funds through the public markets. Smaller companies are finding it less viable to be public companies because of higher governance costs, and they are limited to selling securities through exempt offerings.

The tendency of the securities regulation scholarship over the years has been to look at each of these trends in isolation. Some have criticized the increasing governance costs imposed on public corporations,[2] while others have defended the role of the securities laws in supplementing what they see as lax state regulation of corporate governance.[3] Separately, there has long been debate about whether the federal law governing offerings should be relaxed in various ways to make it less costly for companies to raise funds by selling securities to investors.[4]

The motivating idea behind this essay is that it may be fruitful to examine the relationship between these two trends. Though the securities laws traditionally were thought of as regulating disclosure, governance has become enough of a part of securities regulation such that it can be said that governance costs and public offering costs are two facets of one regulatory system. Regulators might manage the overall burdens of the system through

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[1] *See, e.g.*, U.S. SEC. & EXCH. COMM'N, FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES 59 (2006) ("In our view, public companies today must be more mature and sophisticated, have a more substantial administrative infrastructure and expend substantially more resources simply to comply with the increased securities regulatory burden." (footnote omitted)); Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1820 (2007) ("[The Sarbanes-Oxley Act's] most important effects may be less about investor protection than about renegotiating the boundary between the public and private spaces in big corporations, a much deeper ideological issue.").

[2] *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011); Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

[3] *See, e.g.*, Joel Seligman, *The Fifth Abraham L. Pomerantz Lecture: The New Corporate Law*, 59 BROOK. L. REV. 1 (1993); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003).

[4] *See, e.g.*, Rutheford B Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919 (2011); Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85 (2006).

calibration of these two types of costs. For example, companies can be encouraged to go public despite the resulting governance costs by lowering public offering costs. Or, the relationship might run the other way. Laws imposing governance regulation can be understood in part as a response to liberalization of the regulation of public offerings. More lenient offering rules resulted in a greater risk of fraud, necessitating additional governance measures. The two trends in the regulation of the public corporation have resulted in a system where the right to do a public offering is being conditioned on meeting certain governance obligations.

Admittedly, there are dangers to linking governance and public offering costs. Thinking of these two types of costs as somewhat interchangeable could justify unwise federal preemption of state corporate law. It might be easier to justify ratcheting up governance regulation if reductions in public offering regulation can mitigate the costs of governance. It would be more optimal to look at each area of regulation separately and impose the right level of regulation in each area. However, given the pressure to improve the governance of public companies, it is likely that reform proposals will continue to be implemented, and the question will be how regulators can manage the burdens of governance.

Moreover, thinking of governance and public offering regulation as part of one system suggests that there is an upper limit to which the federal securities laws can be used to impose uniform corporate governance standards on public corporations. At some point, it will not be possible to reduce offering costs to counter increasing governance costs without significantly compromising the investor protection and market efficiency goals of the federal securities laws. Indeed, there are signs that the recent push to increase governance obligations has resulted in legislation that will harm investors. It may be that governance rules are already becoming too burdensome, and that resulting reductions in offering regulation may affect the ability of the securities laws to perform their core function.

This essay has four parts. Part II describes the trend towards using the federal securities laws to regulate corporate governance. Part III describes the SEC's efforts to reduce public offering costs. Part IV discusses the relationship between these two trends and suggests that governance is increasingly a condition of accessing the public offering. Part V discusses some of the arguments against linking governance and offering costs, and notes that a risk of increasing governance regulation is it can result in pressure for legislation that erodes protections for investors.

II. INCREASING CORPORATE GOVERNANCE COSTS

In the United States, corporate governance has traditionally been regulated by state law. While the disclosure requirements of the federal securities laws have long touched on areas of corporate governance, in the last decade or so federal law has been more aggressively extended to regulate corporate governance. Part of the push has been a reaction to scandals at public companies. Another factor is greater activism by shareholders. These developments have increased the costs of being a public corporation and it is likely that the costs will continue to increase.

A. *Governance and Public Corporations*

To the extent that corporate governance is a way of managing agency costs, one would expect that public corporations will naturally have greater governance obligations. Public corporations have more shareholders than private corporations. The greater the number of shareholders, the greater are the costs of agency. Rather than serving two or three masters, the managers of a public corporation serve thousands of owners—increasing the potential for divergence of interests between principals and agents. Thus, corporate law has long distinguished between public and closely held corporations. Shareholders of public corporations are owed fiduciary duties of care and loyalty by the board of directors and managers of the corporation. In contrast, shareholders of closely held corporations are owed a smaller range of duties in some states and virtually no duties in states such as Delaware.[5]

Public corporations face greater disclosure obligations under the securities laws than do private companies. Public corporations must file disclosures when they sell securities to the public, as well as periodic disclosures on a quarterly and yearly basis. One simple reason for this differing treatment is that public companies have more investors who could be defrauded than do private companies. Public investors have less interaction with the managers of the company than do private investors, and so have less direct information about the company than investors in a closely held corporation. Disclosure remedies this asymmetry of information.

The core disclosure obligations of the securities laws touch on issues of corporate governance.[6] The federal securities laws require managers of the corporation to set up reliable internal controls to organize and manage

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[5] *See* Nixon v. Blackwell, 626 A.2d 1366, 1379–80 (Del. 1993).

[6] *See, e.g.*, Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146, 1148–49 (1965) ("Because disclosure is designed to provide investors with the data necessary to make informed judgments, the information required may encompass all aspects of corporate life, and consequently all aspects of corporate life may be affected." (footnote omitted)); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, WIS. L. REV. 297, 310–12 (2009) (describing role of disclosure in improving corporate governance).

information.[7] Given the complexity of the modern public corporation, adequate disclosure is only possible if procedures are in place to verify the accuracy of such disclosure. Reliable information is not just a concern for securities regulation, but also for corporate governance. Without accurate disclosures, it is difficult for the board to assess the performance of the corporation and its managers. Indeed, corporate law has recognized that a board's reckless failure to adequately monitor the corporation can violate the duty of care.[8] The internal controls mandated by the federal securities laws help ensure that the information boards use to monitor and govern the corporation is reliable.[9]

The federal securities laws provide for enforcement mechanisms relating to disclosure that touch on corporate governance issues. The anti-fraud provisions of the securities laws punish managers who make false disclosures to enrich themselves,[10] enforcing a substantive norm similar to the corporate law duty of loyalty. To the extent that a fraud is the result of reckless conduct by managers, a federal securities claim will touch on the corporate law duty of care.

In addition to the federal securities laws and state corporate law, exchanges regulate the governance of public companies seeking a liquid market for their shares. In order for its stock to be traded on an exchange, a company must meet listing standards that measure whether it is suitable for public trading. Though exchanges are technically not government institutions, they are heavily regulated by the SEC and have adopted suggestions by the SEC to implement regulations increasing governance obligations.[11] For example, at the prompting of the SEC, the exchanges have required listed companies to have boards with a majority of independent directors.[12] To the extent that an exchange listing is critical in creating a liquid market for a company's securities, a public corporation

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[7] Securities Exchange Act of 1934 § 13(b)(2), 15 U.S.C. § 78m (2006), *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 102, 126 Stat. 306 (2012).

[8] *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[9] The federal securities laws also regulate corporate voting. Because most shareholders do not attend the corporation's meetings, they must vote through proxy. Public companies typically circulate a proxy statement containing information relevant to the matters that will be voted upon at the meeting. Federal securities law requires that these proxies not be misleading. Securities Exchange Act of 1934 § 14(e). To the extent that shareholders participate in governing the corporation, their participation in governance is shaped by the federal proxy laws.

[10] *See* James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 385 (2010).

[11] *See* Self-Regulatory Organizations, NYSE, Inc. and NASDAQ, Inc.; Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No.48,745, 68 Fed. Reg. 64,154, 64,157 (Nov. 12, 2003).

[12] *See id.* at 64,157.

will have to consent to such governance measures. Because exchange regulation is technically separate from the disclosure regime of the federal securities laws, it is a way of imposing corporate governance reforms on the largest public companies without amending the core securities laws.

It should not be a surprise that public corporations are held to higher governance standards. Corporate law, federal securities law and exchange listing standards all require more of public companies. The questions are whether governance obligations should be increased, and whether the federal securities laws should play a greater role in defining such obligations.

B. *Governance and Scandal*

As a number of commentators have noted, increasing regulation of corporate governance by the federal securities laws has been prompted by major scandals and economic turmoil.[13] Such events prompt legislatures to pass laws that aspire to improve governance of public corporations and prevent scandals in the future. Three of the major laws that have increased the role of the federal securities laws in corporate governance—the Foreign Corrupt Practices Act,[14] the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley),[15] and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[16]—fit this pattern.

The Foreign Corrupt Practices Act was a response to the discovery in the 1970s by investigations growing out of the Watergate political scandal that large public companies were routinely paying bribes while doing business overseas. The SEC brought a number of controversial actions alleging that the failure to disclose these bribes violated the securities laws.[17] The Foreign Corrupt Practices Act imposed federal requirements on public companies to maintain adequate internal controls and accurate books and records, while also prohibiting bribery.[18] The law essentially used the securities regulation principle of full and accurate disclosure to impose a type of anti-corruption norm on public companies. In doing so, it sent the message that disclosure not only serves to protect investors and facilitate

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[13] *See* sources cited *supra* note 2.
[14] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, 15 U.S.C. §§ 78dd-1–3 (2006).
[15] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).
[16] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[17] *See generally* ROBERTA KARMEL, REGULATION BY PROSECUTION (1982) (describing enforcement actions relating to overseas bribes).
[18] Foreign Corrupt Practices Act §§ 102–103.

efficient markets, but also helps ensure that transparency will check the ability of public corporations to act unethically.

In 2002, years after the Foreign Corrupt Practices Act, Sarbanes-Oxley was passed in the wake of the sudden collapse of two large, prominent, public companies: Enron and WorldCom. Section 404 of Sarbanes-Oxley extended the force of a public company's internal controls obligations by requiring the company's management to assess the adequacy of those controls and the company's auditors to attest to that assessment.[19] Under that law, the company's CEO and CFO must certify that the company's periodic reports contain no material misstatements and fairly present the financial condition of the issuer.[20] Sarbanes-Oxley prohibits public companies from extending loans to its managers,[21] while also requiring that audit committees of public companies be composed of independent directors.[22] In addition to regulating areas traditionally the subject of state corporate law, such as board composition and decision-making, Sarbanes-Oxley increased the cost of internal controls by formalizing the process by which such controls would be documented and assessed, making the public corporation more bureaucratic in its governance.

Dodd-Frank was passed after the collapse of major financial institutions during the economic crisis of 2008, which was triggered largely by the collapse of the housing market. Corporate governance problems such as excessive executive pay were seen as creating incentives that resulted in unreasonable risk-taking. Dodd-Frank thus includes governance measures related to executive compensation that are to be implemented through the securities laws. One such provision, the so-called "Say on Pay" law, requires advisory shareholder votes on the company's executive compensation policies.[23] Another Dodd-Frank provision requires that for public companies listed on exchanges, the board committee setting executive compensation be composed of independent directors.[24]

The link between federal corporate governance reform and scandal has resulted in questions about the quality of deliberation with respect to such reform.[25] Costs of greater corporate governance obligations can be difficult

[19] Sarbanes-Oxley Act § 404.
[20] *Id.* § 302.
[21] *Id.* § 402.
[22] *Id.* § 301.
[23] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 15 U.S.C. § 78n-1).
[24] *Id.* § 952.
[25] *See, e.g.*, Lucian A. Bebchuck & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1833–34 (2006) (noting problems with reactive approach to corporate law making). The problems associated with crisis-driven lawmaking have long been acknowledged. *See* Louis Loss, *Contemporary Problems in Securities Regulation*, 45 VA. L. REV. 787, 789

to predict, and in the heat of the moment there can be a tendency to underestimate the burdens of regulation. Indeed, the costs of Sarbanes-Oxley have been much higher than anticipated, reducing the legitimacy of the law.[26] While governance costs are felt immediately, the benefits of corporate governance regulation are difficult to measure. Even when there are long-term benefits to governance legislation, such benefits are often overshadowed by the perception that such laws are too burdensome. The result might be that companies that would otherwise be public might believe it is in their best interest to remain private.

While major governance legislation is often passed after a financial crisis, it is important to recognize that the push for reform is not just driven by the aftermath of economic bubbles. Prominent commentators have proposed federal governance reforms because of long-standing concerns relating to the governance of public corporations.[27] Shareholders have become more sophisticated and active, and have been another impetus for reform. The tension between shareholders and managers may always ensure that corporate governance reform could be put on the agenda. The federal securities laws are a mechanism that can be used to impose uniform governance regulation, and for various reasons, such reforms have been suggested and implemented.

III. REDUCING PUBLIC OFFERING COSTS

As the securities laws have increasingly regulated governance of public companies, they have become more liberal in their regulation of the public offering. The ability to offer securities to the public is what primarily distinguishes public from private corporations. Though companies may also sell securities through exemptions to the securities laws, there are still major advantages to doing a public offering. However, public offerings can be costly,[28] and over the last forty years, efforts have been made to reduce the expense of this process for various reasons.

(1959) ("But the fact must be recognized that technical legislation of the SEC kind seems to come only in times of crises, when . . . in order to take care of everybody's objections, it is apt to be either exceedingly complex or exceedingly wishy-washy or both.").

[26] *See generally* Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229 (2009) (documenting negative media response to Sarbanes-Oxley).

[27] *See, e.g.*, Bebchuck & Hamdani, *supra* note 25.

[28] The costs of offerings, even by established public companies, can be substantial. *See* John J. Moon, *Public vs. Private Equity*, 18 J. APPLIED CORP. FIN. 76, 76 (2006) ("The fees paid to underwriters, auditors, attorneys, and other intermediaries typically run from 3% to 5% of the gross proceeds of an offering for an already public company, depending on the size of the issuance among other factors.").

The baseline for public offerings is the initial public offering, where a company sells equity to the public for the first time. In such an offering, the need for extensive new disclosure is apparent because the company has no public history. The expense of extensive disclosure efforts is justified because valuation of new companies is difficult, and there are concerns that the promoters of the company are taking advantage of investors. Because stock only has value if the company is profitable or will be profitable, investors need special protection—which the securities regulations provide.

As public companies mature, however, they begin to develop a history of disclosures. Secondary markets of publicly traded stocks are constantly monitoring these disclosures and incorporating new information about the company. To the extent that companies issue additional securities over time, there may not be as great of a need to subject a company to the same scrutiny as when it was a new public company. Subsequent offerings by public companies, especially large ones, need not trigger the same extensive regulation as an initial public offering.

To take into account the difference between new and seasoned public companies, the first step in the liberalization of the public offering was the integration of the disclosure requirements of the Securities Act of 1933, which governs public offerings, and the Securities Exchange Act of 1934, which requires public companies to make periodic disclosures. Until integration, each of these statutes imposed different rules for disclosure. Integration simplified the process by setting forth one set of regulations governing the filings under either Act.[29]

With integration, it became possible to streamline the public offering process.[30] Rather than prepare a new set of disclosures for each offering, established companies that were already filing periodic disclosures could simply refer to those disclosure documents when selling securities.[31] In an efficient market, preparing new offering documents is unnecessary because the market will already have incorporated the information from the periodic disclosures. By reducing redundancies in disclosure requirements, integration resulted in significant savings for established public companies.

Integration allowed for shelf registration, which permits certain public companies to quickly sell securities at a time of their choosing.[32] A company can register securities, obtain approval from the SEC and actually

[29] With integration, one regulation, Regulation S-K, governs both Securities Act and Securities Exchange Act disclosures. *See* 17 C.F.R. § 229 (2012).

[30] For an overview of the rationale for integrated disclosure and shelf offerings, see Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

[31] Certain companies can utilize an S-3 short form registration form. *See* 17 C.F.R. § 239.13 (2012).

[32] SEC Rule 415 allows for shelf registrations. *See* 17 C.F.R. § 230.415 (2012).

sell the securities months or years later when market conditions are optimal. Rather than prepare a new registration statement for the later shelf offering, the company can simply incorporate by reference its periodic disclosures.[33]

A 1985 study by Sanjai Bhagat, M. Wayne Marr and G. Rodney Thompson found significant cost savings for shelf registrations.[34] They estimated that shelf registrations cost 13% less for syndicated equity offerings, translating into a savings of $370,000 for the average $58.8 million stock issue in their sample.[35] Public companies now routinely offer billions of dollars in debt through shelf offerings,[36] and even if the savings are not as high as for equity offerings in the mid-80s, it is likely that shelf offerings have resulted in significant savings for public companies permitted to make such offerings.

Though it reduces offering costs, shelf registration also undermines the ability of underwriters to scrutinize public companies each time they offer securities to the public.[37] Because the actual sale of securities occurs months after the filing of the registration statement, and takes a matter of days to complete, the due diligence process that is typical for the initial public offering of securities is shortened.[38] As a result, it is more difficult for the underwriter to root out fraudulent offerings. With shelf offerings, the detection of fraud has been delegated from underwriters to the markets and their participants. Efforts to decrease public offering costs have thus reduced the ability of securities regulation to check poor corporate governance.

The offering process has been further liberalized post-Sarbanes-Oxley. The 2005 Offering Reforms were the culmination of earlier efforts to

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[33] Allowing shelf registrations helped U.S. markets compete with Eurodollar markets where companies could tap funds without the burdens of U.S. regulation. *See* Edward F. Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755, 793 (1981).
[34] Sanjai Bhagat, M. Wayne Marr & G. Rodney Thompson, *The Rule 415 Experiment: Equity Markets*, 40 J. FIN. 1385, 1400 (1985).
[35] *Id.*
[36] *See, e.g.*, Beth Selby, *The Twilight of the Syndicate*, INSTITUTIONAL INVESTOR, Aug. 1985, at 205, 206 (noting that General Motors had underwriting fees of $2.2 million for a $250 million debt offering in 1972, and underwriting fees of $900,000 for a $250 million debt offering in 1985).
[37] For a description of this problem, see Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2018–20 (2009).
[38] *Id.*

streamline the offering process.[39] These reforms made it easier to comply with the gun-jumping rules, which regulate communications during the offering process, by creating a number of bright-line safe harbors for certain communications and allowing for the use of a wider range of written materials to market offerings to investors.[40] The SEC also created a new category of issuer, the Well-Known Seasoned Issuer (WKSI), which can go forward with a shelf offering without SEC review of the registration statement.[41] The largest public companies qualify as WKSIs, reducing the cost of public offerings for those companies. The reforms also essentially did away with the requirement to deliver a final prospectus to investors for most offerings.[42] The reforms were seen as a positive development for issuers by at least one law firm, which declared after their passage: "Santa Claus came early this year for the securities industry."[43]

Two years after Dodd-Frank, the Jumpstart Our Business Startups Act (JOBS Act) was passed to reduce costs for smaller companies that are raising funds from public investors.[44] In addition to a number of other changes to the securities laws,[45] the JOBS Act exempts companies with under $1 billion in annual revenue from some of the requirements of Sarbanes-Oxley and Dodd-Frank for five years after they go public.[46] In particular, such "emerging growth companies" are not subject to section 404(b) of the Sarbanes-Oxley Act for five years,[47] are not subject to mandatory audit firm rotation for five years,[48] are not subject to certain executive compensation disclosures imposed by Dodd-Frank for five years[49] and are permitted to submit draft registration statements to the SEC for review prior to an offering.[50]

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[39] *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005).
[40] *Id.* at 44,735–41.
[41] *Id.* at 44,726–30.
[42] *Id.* at 44,782–86.
[43] BRIAN G. CARTWRIGHT ET AL., LATHAM & WATKINS LLP, CHRISTMAS IN JULY—THE SEC IMPROVES THE SECURITIES OFFERING PROCESS 1 (2005).
[44] Jumpstart Our Business Startups Act pmbl., Pub. L. No.112-106, 126 Stat. 306 (2012).
[45] For example, the JOBS Act created a crowdfunding exemption. *Id.* § 302. For a description of the crowdfunding market, see Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 880–972 (2011).
[46] Jumpstart Our Business Startups Act §§ 101–05.
[47] *Id.* § 103.
[48] *Id.* § 104.
[49] *Id.* § 102.
[50] *Id.* § 105.

In sum, the SEC and Congress have made efforts to reduce public offering costs. As a general matter, these developments have received less attention than the use of the federal securities laws to regulate corporate governance. Over the years, these reforms have likely made it more attractive to be a public company, especially a large one.

IV. THE RELATIONSHIP BETWEEN GOVERNANCE AND PUBLIC OFFERINGS

While they are motivated in part by different policy considerations, the recent trends of increasing governance costs and decreasing offering costs both occur within the legal framework of securities regulation. Rather than view each development as unrelated, this Part argues that there are links between these two trends. To the extent that governance obligations of public corporations are increasing, those costs might be offset in part by reducing offering costs. Or, the relationship might run the other way. Efforts to liberalize offerings may have affected the ability of the securities laws to monitor fraud, prompting an increase in governance requirements. Finally, this Part notes that governance is increasingly a condition to taking advantage of public offerings.

A. *Reducing Offering Costs to Mitigate Higher Governance Costs*

One response to higher governance costs for public companies would be to repeal the legislation imposing such costs. Another possibility might be to modify such laws to exempt certain companies, such as small or foreign companies. If repeal or modification is politically unfeasible or undesirable, a policymaker can restore some balance to the system by cutting regulatory burdens in another area.[51] Reducing offering costs could offset some of the increased costs imposed by governance reform and increase the incentive to become a public company.

In an article written prior to the passage of Sarbanes-Oxley and Dodd-Frank, John Coates made a related point. He observed that the SEC can act as a "circuit breaker" that can moderate legislation passed during a financial crisis.[52] He noted that "[o]ver and over again, the SEC has functioned not only to regulate, but also to keep in check political tendencies to

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[51] *See, e.g.*, Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1072 (2008) ("[R]egulators may also choose not to reform unattractive corporate rules per se, but instead to make their securities regulations more competitive and thereby lower the net costs of issuer compliance.").

[52] *See* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 555–56 (2001).

legislate."[53] At least some of the efforts to liberalize offerings after Sarbanes-Oxley are examples of the SEC trying to mitigate the effects of governance reform passed after periods of financial turmoil. Indeed, with the JOBS Act, Congress itself has acted to reduce some of the costs that it earlier imposed on public companies.

There is evidence that the 2005 Offering Reforms and JOBS Act were in part spurred by the effects of governance reform. Some practitioners speculated that the 2005 Offering Reforms were motivated by a desire to make U.S. securities markets more attractive for foreign issuers after Sarbanes-Oxley.[54] The JOBS Act is even more obviously directed at Sarbanes-Oxley and Dodd-Frank costs by exempting emerging growth companies, firms with under $1 billion in earnings, from some of the requirements of those statutes for five years.[55]

In a sense, the 2005 Offering Reforms and JOBS Act have moved the securities laws in the opposite direction of corporate governance reform. While governance is meant to protect shareholders from abuse by managers, offering reform to some extent accepts compromises in investor protection to make access to the capital markets less costly. Companies that are considering going public will weigh the burdens of governance against the benefits of the ability to do public offerings. By making it less burdensome to do public offerings, regulators can make the prospect of becoming a public company attractive.

At least some of the governance costs of Sarbanes-Oxley have been offset by offering savings from the 2005 Offering Reforms and the JOBS Act. A 2009 study by the SEC's Office of Economic Analysis estimated that the expense of section 404 of Sarbanes-Oxley for public companies averages $2.03 million with a median cost of $1.04 million per year.[56] The cost-savings of the 2005 Offering Reforms have not been studied in as much depth. Indeed, it is difficult to measure precisely how much is saved by the creation of the WKSI category and bright-line offering rules. Certainly, though, these provisions create greater legal certainty that will facilitate public offerings.[57] One estimate prepared by the SEC predicted

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[53] *Id.* at 557.

[54] *See* Leslie N. Silverman & Jeffrey D. Karpf, *The SEC's Securities Offering Reform Proposals: Will This Ship Sail?*, 38 REV. SEC. & COMMODITIES REG. 63, 64 (2005) ("The SEC's proposals are also motivated by its strong interest in attracting a greater volume of transactions to the U.S. public market through registration.").

[55] Jumpstart Our Business Startups Act §§ 103–04, Pub. L. No.112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

[56] U.S. SEC. & EXCH. COMM'N, STUDY OF THE SARBANES-OXLEY ACT OF 2002 SECTION 404 INTERNAL CONTROL OVER FINANCIAL REPORTING REQUIREMENTS 5 (2009) [hereinafter STUDY OF THE SARBANES-OXLEY ACT OF 2002].

[57] It is also important to acknowledge that section 404 has benefits that would offset its costs. Though it is difficult to quantify those benefits, it is likely that there

that the 2005 Offering Reforms will save $130 million per year, a small but not trivial amount.[58] Such a level of savings would offset the annual section 404 costs for about sixty-five public companies. The JOBS Act is also likely to result in some governance savings for smaller companies, at least for the first five years of their existence.

Regardless of whether the reduction of costs from offering reform significantly offsets the costs of Sarbanes-Oxley,[59] looking at the two trends together suggests a strategy for mitigating governance costs. The SEC can find ways to reduce regulations in other areas for public companies and in doing so can lessen the overall costs imposed on public companies by the federal securities laws. Indeed, it is likely that some of the recent offering reforms are at least partly explained by a desire to mitigate the increasing burdens of governance on public corporations.

B. *Increasing Governance Regulation to Offset the Effects of Lower Offering Regulation*

Another possible relationship between governance and offering regulation is that greater governance obligations are necessitated when offering reform increases the risk of fraud in public companies. The effort to reduce offering costs over the last several decades has made it more difficult for gatekeepers to do due diligence on public companies when they periodically offer securities. At least one governance measure, section 404 of Sarbanes-Oxley, is best understood as a way of improving continuous monitoring of the periodic disclosures of public companies.

In a classic article on the puzzle of why companies pay dividends to shareholders, Frank Easterbrook highlighted the importance of public offerings in monitoring public companies.[60] Easterbrook argued that dividends might check agency costs because companies have to go to the capital markets to fund a dividend.[61] With each new securities offering, underwriters scrutinize the company in assessing the accuracy of the

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are significant benefits in improved transparency and more accurate disclosures. *See* STUDY OF THE SARBANES-OXLEY ACT OF 2002, *supra* note 56, at 6–8.

[58] Securities Offering Reform, *supra* note 39, at 44,794–95.

[59] Some commentators are skeptical that offering reform significantly offsets governance costs. *See, e.g.*, Silverman & Karpf, *supra* note 54, at 83 ("Although some foreign private issuers may view the benefits of WKSI status, in particular the immediate access to U.S. capital once they become seasoned, as outweighing the burdens imposed by the Sarbanes-Oxley Act, it is unlikely that this will be the case for many foreign private issuers.").

[60] Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653–54 (1984).

[61] *Id.* at 656.

disclosures relating to the offering.[62] At the time Easterbrook wrote the article, public offerings were more time-consuming and expensive. The benefit of such costs was meaningful due diligence of public companies by market gatekeepers.

With the common use of shelf offerings, the premise behind Easterbrook's argument is no longer as valid. Now, established public companies can initiate and complete offerings within a matter of days. Underwriters do not have as much time to scrutinize the accuracy of disclosures relating to the offering. Indeed, the disclosure for a shelf offering just incorporates by reference periodic disclosures that the underwriter did not participate in drafting. Though shelf offerings are desirable in that they make it less costly for public companies to access securities markets, with shelf offerings, there is less meaningful monitoring of public companies through the underwriting process.[63]

As the SEC reduces regulation of securities offerings, the risk of fraud may increase. The collapse of WorldCom, which helped spur passage of Sarbanes-Oxley, raised issues concerning the ability of underwriters to detect fraud relating to securities offerings by seasoned issuers. While publishing fraudulent financial statements, WorldCom was able to offer billions of dollars in bonds to public investors. Those investors lost much of their investment when the company suddenly collapsed and went into bankruptcy after the accounting fraud was discovered. In litigation relating to these offerings, the underwriters asserted a due diligence defense, arguing that they had relied upon prior work done by auditors and could not have discovered the fraud. A federal district court rejected this argument, finding that the underwriters had an obligation to follow up on red flags relating to WorldCom's financial results, and refused to dismiss the case on summary judgment.[64] The underwriters settled the case for billions of dollars rather than risking trial.[65]

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[62] *Id.* at 654 ("The principal value of keeping firms constantly in the market for capital is that the contributors of capital are very good monitors of managers.").
[63] *See, e.g.*, John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1170 (1995) ("Perhaps irretrievably, underwriters have lost their role as reputational intermediaries in shelf registrations."); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 284 (2009) (noting that the Securities Act liability system "worked well in the past to produce high-quality disclosure, before short form and shelf registration made serious underwriter due diligence for offerings by established issuers impractical.").
[64] *In re* WorldCom, Inc., 346 F. Supp. 2d 628, 674–77 (S.D.N.Y. 2004). For a thoughtful critique of the decision, see John C. Coffee, Jr., *Due Diligence After* WorldCom, N.Y. L.J., Jan. 20, 2005, at 17.
[65] Gretchen Morgenson, *Bank to Pay $2 Billion to Settle* WorldCom *Claims*, N.Y. TIMES, Mar. 17, 2005.

There are links between section 404 and the problems highlighted by WorldCom.[66] Section 404's requirement that auditors assess the company's internal controls is essentially a due diligence obligation. Section 404 requires additional scrutiny of the generative process for the most important item in a company's disclosures, the financial statements.[67] Auditors are in a better position than underwriters of shelf offerings to determine whether a public company's controls are able to detect fraud. Though auditors already performed annual audits prior to the passage of Sarbanes-Oxley, section 404 formally requires greater assessment of internal controls in conjunction with the company's management.

If auditors are doing more to scrutinize internal controls after Sarbanes-Oxley, the liability of underwriters for misstatements relating to shelf offerings might be more manageable. Auditors will catch more frauds that could lead to underwriter liability for a shelf offering, reducing the risk of a section 11 suit for both auditors and underwriters. Indeed, despite the high standard for due diligence set forth in WorldCom, a case could be made that the standard for underwriter due diligence should be lessened in light of section 404. With section 404, underwriters should be able to argue that they have greater reason to rely on the expert determinations of these auditors with respect to the adequacy of internal controls. An underwriter facing liability in a section 11 suit for a shelf offering where there is accounting fraud might point to the auditor's section 404 certification as providing the underwriter with reasonable assurance as to the validity of the company's financial statements.

Section 404 certainly increases governance costs borne by the issuer and potentially by auditors who might be held liable for a failure to find fraud. An auditor might be compensated for this increased potential liability through higher fees earned by doing section 404 assessments and

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[66] Indeed, prior to WorldCom and Sarbanes-Oxley, Donald Langevoort proposed that greater scrutiny of internal controls might be a way to improve the monitoring of shelf registrations, though he would have accompanied such controls with less exposure to fraud on the market liability for issuers. *See* Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 47 (2000) ("I would, however, create a much more determinate obligation on the part of seasoned issuers to implement an efficient disclosure monitoring system, an elaboration of the current obligation to have a reasonable system of internal controls found in Section 13(b)(2)(B) of the Securities Exchange Act . . . .").

[67] The WorldCom fraud was facilitated by the lack of adequate internal controls. *See* RICHARD C. BREEDON, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI 15 (2003) ("[T]he Company's internal controls over the preparation and publication of its financial results were dysfunctional at best, and in some areas controls were missing entirely.").

certifications. Part of the greater costs of Sarbanes-Oxley can be understood as a subsidy to the auditing industry, increasing the resources auditors have to monitor companies. The question for issuers is whether the costs of section 404 are offset by the savings they receive from the ability to do shelf offerings and the greater trust investors will have in the financial statements of those public companies.

Linking section 404 to the problem of shelf offerings suggests a natural limit to its application to public companies. If section 404 is understood as a method of continuous due diligence, it might be limited to companies qualifying to do shelf offerings. Another possibility is that section 404 could be limited to the largest companies, the WKSIs, that can do offerings without approval of the SEC. For WKSIs, significant fraud has greater social consequences, and the need for monitoring is more likely worth the cost. Regardless of where the line is drawn, as has been noted before, examining the relationship between governance and offerings shows that section 404 makes the most sense for larger public companies that are permitted to do offerings on short notice.

Some of the governance rules Congress imposed through Sarbanes-Oxley were in part prompted by problems created by earlier offering reforms. Lenient regulation in one area may have indirectly resulted in greater regulation in another area.

C. *Governance as a Condition to Being Public*

The increasing use of the securities laws to impose corporate governance requirements can also be understood as making a normative point. Higher levels of governance are the cost of easier access to the public markets.[68] For better or worse, the securities laws are no longer limited to promoting full and fair disclosure, but are increasingly playing a more substantive sorting role with respect to what companies should be public.

Recent reforms have been driven by a complex set of interacting considerations. Offering reforms contributed to frauds that prompted governance reform. As governance reform becomes burdensome, regulators respond by implementing additional offering reforms to offset the costs of governance requirements. Regardless of how the costs ultimately balance out, governance and its costs have become a persistent presence in securities regulation.

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[68] This point is not a new one. *See, e.g.*, Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 WILLAMETTE L. REV. 707, 735 (2005) (noting position of former chief accountant for the SEC that disclosure standards are "part of the price of being a public company. If you don't want to pay the price, go private.").

The distinction between public and private companies rests on the view that public companies are in some way different than private companies.[69] The failure of a public company generally impacts more investors than the failure of a private company. The collapse of large public companies such as Enron and WorldCom had a societal impact that shook faith in public markets, and harmed numerous stakeholders in those corporations. Whether or not better governance could have prevented such events, efforts at governance reform reflect the view that public companies should be held to higher standards because of their importance.

The trend towards conditioning access to the public markets on higher levels of governance raises questions about whether smaller companies should be encouraged to be public. Larger companies can easily afford governance costs, but entrepreneurial companies often do not have the resources to invest in governance. As described by a number of commentators, the costs of widening the gap between public and private companies are numerous.[70] Smaller companies will have to find sources other than public markets to raise capital. Investors will not have as many opportunities to invest in promising companies. Innovation that comes from a vibrant market for small companies will be stifled.

It is likely that securities regulation will continue differentiating between types of companies and their access to the markets. As described earlier, the JOBS Act is an effort to carve out alternative avenues for smaller companies so they can raise capital without taking on greater governance obligations, at least for a transitional period. As they deal with competing policy considerations, securities regulators will have to make adjustments to both governance and offering requirements in a way that balances the multiple concerns that are shaping the distinction between private and public companies.

V. LINKING GOVERNANCE COSTS AND OFFERING COSTS

If regulators are using offering reform to offset the costs imposed by governance reform and vice-versa, the question is whether this relationship should continue, or whether it should be discouraged. Despite the appeal of calibrating securities regulation by matching increased regulation in one

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[69] For a recent articulation of this view, see Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137 (2011). For a more skeptical view of the distinctiveness of public companies, see Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, GEO. L.J. (forthcoming 2012) (noting that most public companies do not have the footprint of companies such as Enron and WorldCom).

[70] Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1, 7–10 (2007).

area with reduced regulation in another, there are dangers to linking governance and offerings. An argument could be made that we should primarily look at each area independently in assessing whether regulation is warranted or unwarranted.

An obvious problem with the contention that reductions in offering costs can counteract higher governance costs is that such costs are difficult to measure and compare. There is not enough evidence to conclude that offering reforms have resulted in savings that significantly mitigate the burdens of governance reforms. At times, comparing such costs requires looking at apples and oranges. Will saving administrative expense by eliminating final prospectus delivery requirements meaningfully offset the wide-ranging burdens of section 404? It may be that offering costs are not nearly as intrusive as governance costs; thus, reducing offering regulation may not do much to counter more governance regulation.

The problem is not limited to comparing reforms in different areas, but also assessing the effectiveness of each reform on its own terms. It is difficult, if not impossible, to accurately measure the costs, benefits and net effects, of many regulatory changes. Governance reforms have their costs, but they also have benefits, such as more accurate public company disclosure, that may make those burdens worthwhile. Offering reforms have their benefits, but also may result in costs, such as a greater risk of fraud.

Despite this uncertainty, regulators must make choices among different alternatives. Even if the exact costs are not measurable, judgments can be made that increased regulation in one area can be mitigated by less regulation in another area. Even if the costs of reforms cannot be precisely quantified and compared, over time, regulators should have a sense whether the system as a whole is working or not. At the very least, looking at governance and offering regulation together rather than in isolation is a more sensible way of assessing the effectiveness of the regulatory system. Linking governance and offerings gives regulators another tool to understand and assess the regulation of companies offering securities to the public.

Another objection might be that offsetting the burdens of governance through offering reform could allow problematic governance rules to survive. Indeed, if there is a perception that governance regulation can easily be managed by reducing regulation in other areas, there would be an incentive to pass further governance proposals. The jury is still out on whether governance reform will lead to meaningful benefits.[71] If it turns out that such reforms do not work, regulators should strive to repeal or modify

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[71] *See, e.g.*, Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1832–36 (2008); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 239 (2002).

those measures.[72] Ideally, both the set of rules regulating (or not regulating) governance and the set of rules regulating (or not regulating) offerings should each be as efficient and cost-effective as possible. To the extent that offering reform dampens efforts to repeal problematic governance rules, the regulatory system will be second-best or worse.

It may be, though, that under the circumstances, a second-best regulatory system is all that can be hoped for. There are powerful forces pushing for greater use of federal law to regulate corporate governance, and some unwise measures will be passed. The only viable response in some circumstances might be rear-guard measures that reduce regulatory costs in other areas. Moreover, some governance measures may, in fact, be effective. Only the passage of time will tell whether the recent efforts to regulate governance through the securities laws will be successful. In the interim, the uncertainty caused by such costs can be managed in part through thoughtful calibration of the regulatory system.

Finally, thinking of governance and offering regulation as part of one system suggests an upper limit to governance reforms. Offering reform cannot forever check the costs of governance reform. To the extent that more and more governance rules are passed, there will be more and more pressure to reduce offering regulation. Offering regulation can only be cut so much without compromising the interests of investors and markets.

Indeed, given that governance regulation can spur less regulation of offerings, an argument against governance reform is that it will result in deregulation that harms investors. The JOBS Act in particular has provisions that have been criticized because they may facilitate fraudulent schemes.[73] To the extent that the JOBS Act was in part a reaction to the burdens of Sarbanes-Oxley and Dodd-Frank, governance rules have resulted in less protection for investors. If governance does little to improve the performance of public companies, and results in dismantling laws that protect investors, the push to increase federal regulation of corporate governance will have detrimental effects.

At least in theory, there is some point where the burdens of using the federal securities laws to regulate corporate governance will be too great. Governance requirements cannot reach a point where the benefits of becoming a public company are overwhelmingly outweighed by the costs of governance. Governance can only be an effective condition of accessing the public markets if the benefits of such access outweigh the costs. Whether or not we have reached such a state of affairs is yet to be seen.

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[72] Another option would be to include sunset provisions in legislation passed pursuant to a financial crisis. *See* Romano, *supra* note 2, at 1599–602.

[73] *See, e.g.*, Michael Rapoport, *In Wake of Groupon Issues, Critics Wary of JOBS Act*, WALL ST. J., Apr. 2, 2012.

VI. CONCLUSION

For better or worse, the federal securities laws are playing a significant role in defining the shape of the public corporation. On the one hand, greater governance is expected of companies that can sell securities to the public. On the other hand, public offerings are becoming easier for larger public companies. Any company considering whether to become public will have to weigh the costs of governance against the benefits of public offerings. Regulators can adjust regulatory costs in one area to take into account developments in another area. It is unclear whether the costs imposed by the first trend will be meaningfully offset by savings from the second trend. Indeed, there are likely limits to the amount of governance that can be required of public companies. Already, the trend towards increasing governance has resulted in pressure to weaken protections for investors. Regulators should be cognizant of these concerns as they define the line between public and private companies.